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BEFORE THE

POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268–0001

INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS	Docket No. RM2017-1

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE
(January 23, 2017)

On November 22, 2016, the Commission initiated this proceeding with the issuance of an advance notice of proposed rulemaking in Order No. 3624.[1] The Order sought initial comments by January 23, 2017, and reply comments by March 9, 2017. Parties were invited to provide written comments to aid the Commission's examination of the appropriateness of the current required contribution level for competitive products. The Postal Service hereby provides its initial comments on that topic.

Unredacted versions of these comments, and of the supporting Excel workbook - RM2017-1 Analysis-nonpublic.xlsx, are being filed separately under seal with the Commission. The Postal Service's Application for Non-public Treatment of materials filed under seal is appended to this pleading as Attachment 1.

I. INTRODUCTION

The current state of the competitive delivery market provides no basis for an appropriate share requirement at this time, and certainly not for one higher than the current 5.5 percent level. As the Commission noted in Order No. 3624, in undertaking this examination in the past, the Commission considered circumstances such as a lack

[1] Advance Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, PRC Docket No. RM2017-1 (Nov. 22, 2016).

of evidence of a Postal Service competitive advantage; the market share analysis; changes to the market and competitors; historical competitive contribution levels; changes to competitive product offers and the mail mix; and uncertainties raised in the proceeding.[2] Such circumstances are equally appropriate for the current inquiry, and a careful evaluation of each consideration compels the conclusion that the current share level should be set at zero, or at a minimum be reduced from the current 5.5 percent level (but certainly not raised).

At the outset, it is useful to articulate the purpose for the appropriate share provision under section 3622(a)(3) and how it fits into the broader regulatory scheme established in the Postal Accountability and Enhancement Act (PAEA). The appropriate share provision does not exist in a vacuum, as the PAEA regulatory system already incorporates a series of mechanisms to protect fair competition. Under the statute, Congress intended to give the Postal Service pricing flexibility comparable to the private sector for its competitive products, while protecting the public interest against unfair competition in the markets within which competitive products are offered.[3] Section 3633 and other provisions of the PAEA preclude anti-competitive pricing and subsidization by market dominant products of competitive products; otherwise, rates for competitive products are subject to market conditions.

Section 3633 contains three provisions that act in concert to protect fair competition: subsection (a)(1) prohibits the subsidization of competitive products by

[2] *Id.* at 2 (discussing Order No. 1449, Order Reviewing Competitive Products' Appropriate Share Contribution to Institutional Costs, PRC Docket No. RM2012-2 (Aug. 23, 2012), at 24-26).

[3] *See* H.R. REP. NO. 109-66, pt. 1, at 46 (2005); *see also* Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, Docket No. RM2007-1 (Aug. 15, 2007), at 72.

market dominant products; subsection (a)(2) requires that each competitive product cover its attributable costs; and subsection (a)(3) authorizes the Commission to determine the appropriate share of institutional costs that competitive products collectively must cover ("appropriate share").[4] Each of these provisions is an independent safeguard against unfair competition.[5] For example, under section 3633(a)(1), the Commission established the incremental cost test to rigorously guard against the possibility that competitive products are receiving any cross-subsidy by market dominant products. No additional test or check is required for that purpose.[6] Meanwhile, section 3633(a)(2) guards against predatory pricing by requiring that each competitive product cover its attributable cost.

The appropriate share provision offers yet "another level of protection against unfair competition or anti-competitive pricing on the part of the Postal Service."[7] By ensuring that the Postal Service and its competitors have the opportunity to compete on a balanced playing field, the provision effectively serves as a mechanism by which the Commission may correct a market imbalance in favor of the Postal Service.[8] Stated another way, it is one of many tools that allow the Commission to address the net effect

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[4] Order No. 26 at 64.

[5] *Id*. at 66 n.52.

[6] The PAEA contains many other measures to protect fair competition. *See, e.g.*, H.R. REP. NO. 109-66, pt. 1, at 44-45 (2005); S. REP. NO. 108-318, at 27-29 (2004). As a further safeguard, the PAEA requires that estimates of the relevant costs of the various postal products must be derived using the analytic methodologies established by the Commission for that purpose, and the Annual Compliance Review process ensures that the Postal Service is following those methodologies.

[7] Order No. 1449 at 15; *see also* S. REP. NO. 108-318, at 14-15 (describing the Senate bill's version of section 3633(a)(1)-(3) as "appropriate safeguards to ensure that a level playing field is maintained and that the Postal Service does not unfairly compete" and as "ensur[ing] that the Postal Service competes fairly in the provision of competitive products").

[8] *See* Order No. 1449 at 13, 25.

of advantages and obligations arising from the various laws under which the Postal Service operates, and which could – at least in theory – tilt the playing field in favor of the Postal Service.[9]

When Congress passed the PAEA, and even when the Commission first set an appropriate share level, there was no assessment of the existence and direction of any such tilt: the Federal Trade Commission (FTC) had not yet performed its assessment under section 703 of the PAEA. Now, however, it is well known that the FTC found the net effect to be a playing field tilted against the Postal Service's competitive products, not toward them. Absent evidence that the playing field has been somehow tilted in favor of the Postal Service since that time, there should be a presumption that no additional correction is needed to handicap the Postal Service's ability to compete.

Indeed, given all of the other competitive protections, it is critical that the extra protection of the appropriate share provision be employed prudently, so as not to injure consumers by pricing the Postal Service out of the market. The risk of harming the Postal Service's ability to compete by setting a floor that is too high is no less a concern than allowing the Postal Service to gain an unfair competitive advantage.[10] The Commission should remain as mindful of an existing tilt against the Postal Service as it has been in protecting against a theoretical tilt in favor of the Postal Service. Unfairly hamstringing the ability of the Postal Service to compete by overstating the appropriate

[9] It is worth emphasizing that the requirement was not intended to serve as a surrogate for stand-alone cost coverage. If Congress had intended the appropriate share merely to be a proxy for stand-alone costs, then it would have been meaningless for Congress also to require the Commission to consider market conditions when evaluating, or even eliminating altogether, the appropriate share contribution.

[10] The Commission has acknowledged that establishing the appropriate share involves balancing the risk of impairing the Postal Service's ability to compete against the risk of giving the Postal Service an unfair competitive advantage. Order No. 26 at 73.

share requirement could have two significant deleterious effects: (1) it would lessen the overall price and service competitiveness in the market to the detriment of consumers; and (2) it would harm the ability of the Postal Service to fund the network infrastructure needed to provide universal service through its competitive products.

As a practical matter, market share serves as one empirical indicator of the actual need for the appropriate share provision at any given time. Such an evaluation is codified in section 3633(b), in the language directing the Commission to consider “the prevailing competitive conditions in the market.” If the Postal Service is gaining significant market share that cannot otherwise be explained, then it might be reasonable to infer a tilt in the playing field that could warrant invoking the provision. In contrast, if the Postal Service’s market share is stable (or declining), then there is strong evidence of an even playing field, the importance of the provision is diminished, and the appropriate share requirement should at the very least be reduced, if not eliminated.[11]

At this juncture, as shown below, the totality of circumstances contributing to the prevailing competitive conditions manifest no evidence of any tilt in favor of the Postal Service. Therefore, following the analytical framework set forth by Order No. 1449, the

[11] That the statute explicitly authorizes elimination of the appropriate share requirement indicates that Congress contemplated that market conditions, and the competitive protections elsewhere in the statute, could be sufficient to ensure fair competition in the absence of that requirement. Indeed, the Postal Service finds it difficult to envision a scenario in which competitive conditions enable it to set prices for its competitive products to generate contribution, but it would nonetheless choose for its competitive products to contribute nothing to institutional costs. No rational firm in a competitive market would choose to set prices merely at attributable costs under those circumstances. The irrationality of such a decision is amplified by the fact that the Postal Service has strong incentives to generate contribution from the competitive side, to help ensure its financial sustainability and fulfill its universal service obligation, particularly as market-dominant volumes decline. *See* Order No. 26 at 72 (noting the Postal Service’s “incentives to exceed” any appropriate share threshold). Under these conditions, and provided that the benchmark is not set too high, the minimum contribution level does not dictate the Postal Service’s pricing decisions with respect to competitive products. This is further borne out by competitive products’ history of contributing more than the minimum share to institutional costs.

current 5.5 percent appropriate share requirement should be eliminated, or at a minimum reduced; in any event, there is certainly no basis to raise it at this time.

II. THE COMMISSION SHOULD ELIMINATE OR REDUCE THE CURRENT APPROPRIATE SHARE LEVEL

It has been almost five years since the Commission issued Order No. 1449 and left the "appropriate share" target at the level set previously of 5.5 percent of institutional costs. To be sure, the world is not static, and there have been material developments over that period affecting the markets in which the Postal Service's competitive products are offered. Considering these developments, current analysis of the same series of factors examined by the Commission in Docket No. RM2012-3 supports the elimination or reduction of the existing "appropriate share" level, and certainly supports an appropriate share level no higher than 5.5 percent.

A. The Available Evidence Continues to Show That the Postal Service Is at a Net Competitive Disadvantage.

In Order No. 1449, the Commission considered the question of whether the Postal Service benefited from net competitive advantages that its competitors lacked, and reached the sound conclusion that the Postal Service did not. The same conclusion holds true in the current proceeding.

At this time all evidence points to a thriving competitive market. Private carriers continue to dominate the delivery market (as discussed in section II.B below), but consumers benefit from the relative affordability and ubiquity of the Postal Service's competitive products. This consumer benefit is twofold, in terms of the direct availability of affordable prices and the indirect discipline that it imposes on competitors' pricing. Consumers also benefit from the Postal Service's sharing of its network economies with competitors through its last-mile delivery products, which thereby lower the price of competitors' offerings. And although "[t]he Commission's task is to protect competition, not particular competitors,"[12] the major private delivery companies are hardly hampered in their ability to serve the market. To the contrary, they "are profitable, growing, and investing heavily in expanding their capacity and improving their technology."[13] Any suspicion that the Postal Service might be "unfairly competing in a tilted playing field is not borne out by the actual results of [UPS and FedEx's] operations."[14]

When addressing this issue in the past, the Commission relied in part on a report prepared by the FTC that identified "the federal and State laws that apply differently to the United States Postal Service with respect to the competitive category of mail and to private companies providing similar products."[15] The FTC Report was mandated by the PAEA and was issued in December 2007.[16] The Commission noted the FTC's findings that, in spite of any implicit subsidies afforded to competitive products from the Postal Service's status as a Federal government entity, Federally-imposed restraints on the Postal Service's operations increased its costs to provide competitive products and left the Postal Service at a net competitive disadvantage.[17]

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[12] Comments of Amazon Fulfillment Services, Inc., PRC Docket No. RM2016-2 (Jan. 27, 2016), at 73 (citing *Direct Marketing Assn v. United States Postal Serv.*, 778 F.2d 96, 106 (2d Cir. 1985); Order No. 1448, Order Approving Addition of Valassis Direct Mail, Inc. NSA to the Market Dominant Product List, PRC Docket No. MC2012-14 (Aug. 23, 2012), at 26-27) (emphasis in original).

[13] Comments of Amazon Fulfillment Services, Inc., PRC Docket No. PI2016-3 (June 14, 2016), at 3 (citation omitted); *see also* Public Representative Comments, PRC Docket No. RM2016-2 (Jan. 27, 2016), at 51-52 (analyzing FedEx and UPS's profit figures and concluding that they "indicate healthy, highly profitable, businesses in competition with the Postal Service").

[14] Public Representative Comments, PRC Docket No. RM2016-2, at 52.

[15] FED. TRADE COMM'N, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS 1 (2007) [hereinafter "FTC Report"].

[16] *Id.*; *see also* Pub. L. No. 109-435, § 703, 120 Stat. 3198, 3244 (2006).

[17] Order No. 1449 at 14-15 (citing FTC Report at 64-67).

> The magnitude of these subsidies is significantly smaller than the USPS's estimated economic burdens. . . . Based on the estimates above, the USPS's unique legal status appears to cause it to suffer a net competitive disadvantage relative to its private competitors. . . . Thus, even if the USPS were required to account for the value of the implicit subsidies that we have estimated, its legal constraints still would cause it to incur costs that are $213-$743 million higher than they might otherwise be, with the caveat that this range is based only on estimates of those burdens and benefits that we have been able to quantify.[18]

No credible study has undermined the fundamental validity of the FTC's findings.[19] If anything, the FTC Report significantly understates the Postal Service's net competitive disadvantage, because the FTC failed to include several significant and expensive legal differences between the Postal Service and private employers. For example, the FTC counted the Postal Service's inability to access prescription drug subsidies under Medicare Part D, but it overlooked federal employee health benefits' lack of mandatory integration with Medicare Parts A and B, as well as various multi-billion-dollar differences in retirement benefits and workers' compensation.[20] Nor, as

[18] FTC Report at 58, 64 (emphasis added). The range in dollar values largely reflects the factor used to allocate advantages and disadvantages to competitive products. The FTC presented two alternative allocations: one using the Commission's 5.5-percent "appropriate share" determination and one using competitive products' share of total revenues (then approximately 13 percent). The choice of allocation factor raises or lowers both sides of the equation in tandem, and therefore does not affect the basic point that competitive products' legal disadvantages overwhelmingly outweigh their advantages, no matter what allocation factor is used. *Cf.* Reply Comments of the United States Postal Service on Proposals One and Two, PRC Docket No. RM2016-2 (Mar. 25, 2016), at 5 fn.4 (explaining, similarly, why transfers of products from the market-dominant to the competitive product list might increase the magnitude, but not alter the existence, of the substantial net disadvantage that the FTC found).

[19] The sole attempt to do so – one solicited and paid for by a Postal Service competitor – is so riddled with flaws as to bar it from the ranks of the credible. *See* Comments of Amazon Fulfillment Services, Inc., PRC Docket No. PI2016-3, at 8-10; Initial Comments of the United States Postal Service on UPS Proposals One and Two, PRC Docket No. RM2016-2 (Jan. 27, 2016), at 48-50.

[20] *Compare* FTC Report at 39, 56 *with* H.R. Rep. No. 114-848, at 6-7 (2016) ("Despite [its] contributions [to Medicare], the Postal Service is at a relative disadvantage compared to private sector companies. This is because private sector companies can require their retirees to fully enroll in Medicare in order to receive any additional health care benefits in retirement, but the Postal Service cannot require its retirees to enroll in Medicare. As a result, the agency is forced to contribute billions to Medicare for which it receives no benefit if its employees and retirees do not enroll in Medicare."); *id.* at 5-6 (estimating, as one impact from full Medicare integration, the resulting reduction in the Postal Service's unfunded retiree

various parties have pointed out, did the FTC account for private delivery companies' superior freedom and flexibility to conduct their business or their own economies of scale and scope.[21]

To further explore the possibility of competitive advantage, the Commission in Order No. 1449 also considered whether there was any evidence of predatory pricing on the part of the Postal Service.[22] The Order stated that for predatory pricing to occur, the Postal Service would have to price its competitive services below their marginal cost.[23] There are, of course, other statutory provisions to safeguard against such a pricing strategy, and the Commission monitors compliance with those provisions each year in the Annual Compliance Determination. As was the case in Order No. 1449,

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health benefits liability from $54 billion to approximately $0.4 billion); *see also* Comments of Amazon Fulfillment Services, Inc., PRC Docket No. PI2016-3 (June 14, 2016), at 8; United States Postal Service Reply Comments, PRC Docket No. PI2014-1 (Oct. 1, 2014), at 6-7; Library Reference PRC-LR-PI2014-1/1, Postal Service Analysis of Additional Postal Service Activities That Could Qualify for Reporting Under 39 U.S.C. § 3651(b)(1)(C) (Aug. 22, 2014), at 4-10, 12-14. Even with respect to Medicare Part D benefits, the FTC report does not reflect that many private employers now opt to offer such benefits through an employer group waiver plan (EGWP), which can yield substantially greater cost savings than the retiree drug subsidies that the FTC tallied. *See, e.g.*, California Public Employees' Retirement System, Circular Letter No. 600-059-12, Medicare Part D Prescription Drug Plan (Dec. 14, 2012), at 1 (estimating that the change from retiree drug subsidies to an EGWP would lower premiums by 14 to 22 percent).

[21] Reply Comments of Amazon Fulfilment Services, Inc., PRC Docket No. RM2016-2 (Mar. 25, 2016), at 12 fn.6 ("Any analysis of the competitive advantages conferred by economies of scale and scope must also consider the economies of scale and scope that UPS and FedEx enjoy from lines of business in which the Postal Service's share is much smaller (international service) or nonexistent (parcels weighing more than 70 pounds, heavy freight, supply chain management, international trade consulting, corporate financing, billing and collection services, and document services)." (citations omitted)); Public Representative Comments, PRC Docket No. RM2016-2, at 49-50 (pointing out that any putative Postal Service advantage from economies of scale and scope "is offset by a similar advantage by competitors' access to their own production volumes not reasonably available to the Postal Service"); Initial Comments of the American Catalog Mailers Association, PRC Docket No. RM2016-2 (Jan. 27, 2016), at 38 (listing such UPS "strengths," relative to the Postal Service, as "a better labor contract; a processing and distribution network tailored specifically to the handling of parcels; freedom to enter into contracts with customers, selectively, without regulatory oversight; freedom to craft the levels and universality of it[s] service, and freedom to do such things as offer loss-leaders").

[22] Order No. 1449 at 14.

[23] *Id.*

there is no basis to conclude that the Postal Service has used predatory pricing to obtain a competitive advantage. For example, in its 10-K report for FY2014, FedEx discussed the risks of operational disruptions that could affect Postal Service pricing, but made "no reference to any risk from Postal Service pricing, below cost, its products that compete with FedEx products."[24] As also discussed in Order No. 1449, the continued absence of antitrust claims against the Postal Service is likewise indicative of the lack of predatory pricing or similar anticompetitive behavior.[25] Overall, the Commission should reaffirm its finding in Order No. 1449 that the Postal Service has not been shown to benefit from competitive advantages with respect to competitive products, and therefore there is no reason to raise the appropriate share requirement, which instead should be set at zero or, at a minimum, should be reduced below its current level.

B. The Postal Service's Position in the Domestic Package Delivery Market Is Virtually Unchanged Since the Commission's Last Review of the Appropriate Share Requirement.

In Order No. 1449, the Commission concluded that "the lack of a significant increase in market share minimizes concerns that the Postal Service may have an

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[24] Public Representative Comments, PRC Docket No. RM2016-2, at 52.

[25] Further buttressing this conclusion is the fact that rates for competitive products have risen much more substantially than those for market dominant products overall. Under the PAEA, the cumulative CPI-based price-change authority (e.g., excluding the temporary effects of the exigent surcharge) for market dominant products has been +19.1 percent (compounded). By way of comparison, ten price adjustments between May 11, 2008, and January 22, 2017, have raised published Priority Mail prices by a cumulative 44.4 percent. These included two substantial increases: 6.3 percent in January 2013 and 9.8 percent in January 2016. Two other very significant competitive products, Parcel Select Lightweight and First-Class Package Service, have seen cumulative price increases of 92.8 percent and 38.4 percent, respectively, since their transfers from the market dominant products list to the competitive products list in FY 2012. While certainly not dispositive on the technical issue of whether prices for competitive products meet the definition of "predatory," this comparison is indicative of a pricing strategy that is anything but anticompetitive.

artificial advantage over its competitors."[26] An analysis of the market shares of the Postal Service and its two main competitors, UPS and FedEx, confirms that the 5.5 percent requirement is not providing the Postal Service with an unfair competitive advantage, and hence justifies the same conclusion in this proceeding.

Since the Commission last reviewed the appropriate share requirement in Docket No. RM2012-3, the Postal Service's position within the package delivery market[27] has remained virtually unchanged. As shown in the first tab of Excel workbook RM2017-1 Analysis-nonpublic.xlsx, filed concurrently with these comments, the Postal Service's competitors controlled 81.7 percent of domestic package revenues in 2015, while the Postal Service controlled 18.3 percent.[28] These shares are virtually unchanged from 2011, when the Postal Service's competitors controlled 83.9 percent of domestic package revenues and the Postal Service controlled 16.1 percent.[29]

To be sure, the market as a whole has grown substantially due to the rise of e-commerce. Combined Postal Service, UPS, and FedEx domestic package revenue grew 17 percent between 2012 and 2015.[30] While the Postal Service's total domestic competitive-product revenue grew at double that rate during the same period, this

[26] Order No. 1449 at 18.

[27] For purposes of this exercise, references to the package delivery market refer to the portion of the market controlled by the three major carriers, as other providers collectively account for only a tiny percentage of the overall market. In addition, the Postal Service has adjusted the analysis to account for the impact of product transfers.

[28] RM2017-1 Analysis-nonpublic, tab 1, cells J37, J38, J39. At the time of this filing, UPS has not yet released its Form 10-K for FY2016. Accordingly, the Postal Service is unable to provide a similar market share analysis through FY2016. However, where possible, the Postal Service has used FY2016 figures to conduct its analysis. Should UPS' Form 10-K become available during the pendency of this proceeding, the Postal Service will file updated market share numbers.

[29] Initial Comments of the United States Postal Service on Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Docket No. RM2012-2 (Apr. 10, 2012), at 7.

[30] RM2017-1 Analysis-nonpublic, tab 1, cells G34, J34.

difference is entirely attributable to three major customers (the "Big Three"). The Big Three's share of the Postal Service's total domestic competitive volumes surged from [redacted] in FY2012 to [redacted] in FY2016.[31] Without the Big Three, the Postal Service's total domestic competitive-product revenue grew [redacted] between 2012 and 2015: [redacted][32] [redacted] Moreover, it is obvious that the Postal Service's competitive product growth has been highly leveraged, exposing it to significant risks of erosion in the coming years, as discussed in Section II.C below.

A significant amount of the Postal Service's domestic competitive-product revenue growth is attributable to its growing role as a last-mile package delivery provider, including for the Big Three. The Postal Service's domestic competitive product revenues increased by 57.8 percent between 2012 and 2016.[33] However, when Destination Delivery Unit (DDU) revenues are removed, the increase in domestic competitive product revenues (over the same period) drops [redacted].[34] Similarly, the Postal Service's domestic competitive product volumes grew by 67.3 percent between 2012 and 2016. However, this growth shrinks to [redacted] when

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[31] RM2017-1 Analysis-nonpublic, tab 2, cells G29, K29.

[32] *Id.* at tab 1, cells L25, L34.

[33] *Id.* at tab 1, cell M23.

[34] *Id.* at tab 1, cell M26. DDU packages include Parcel Select items entered at the Destination Delivery Unit.

domestic DDU packages are removed.[35] DDU volume is even more heavily concentrated than competitive products overall: [redacted] of all domestic DDU volumes can be traced to the Big Three.[36]

If nothing else, these statistics demonstrate the significant influence that DDU packages, and the Big Three [redacted], have on the Postal Service's domestic competitive product volumes and revenues. Indeed, a substantial drawdown of DDU volume, or even of the Big Three's DDU volumes, could have an outsized impact on the Postal Service's ability to maintain its current levels of competitive product contribution. Moreover, the risk of losing volume from the Big Three cannot be dismissed as mere conjecture, as each entity's efforts to divert DDU volume away from the Postal Service is a matter of public record.[37] Accordingly, the Commission cannot assume that the Postal Service's current market share will be maintained over the next

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[35] RM2017-1 Analysis-nonpublic, tab 2, cells L23, L26.

[36] *Id.* at tab 2, cell K32.

[37] [redacted]

five years, and there is no basis to increase the appropriate share based upon recent minor market share gains by the Postal Service. Rather, the appropriate share requirement should be set at zero or, at a minimum, should be reduced below its current level.

C. Changes to the Domestic Package Delivery Market and Competitors Could Threaten the Postal Service's Competitive Position.

In determining the appropriate share of institutional costs that competitive products should cover, the Commission is directed to consider "all relevant circumstances, including the prevailing competitive conditions in the market." 39 U.S.C. § 3633(b). As the Commission has noted, this determination includes consideration of changes to the market since the Commission's last review.[38]

Over the past five years, prevailing competitive conditions have changed in several respects. First, the explosive and continuing growth in e-commerce shipping volumes has been accompanied by steadily increasing customer demands and expectations. E-commerce is trending more toward business-to-consumer (B2C) than business-to-business (B2B) deliveries, with more parcels being shipped overall, but involving higher last-mile expenses and tighter margins. (As a category, consumers have fewer parcels delivered to more addresses than businesses do, and typically return more items to retailers.) Consumers now expect faster delivery times at lower or no cost to them, and shippers are adjusting their strategies to meet these increased expectations.[39]

[38] Order No. 1449 at 18.

[39] *See* UNITED STATES POSTAL SERVICE OFFICE OF THE INSPECTOR GENERAL, RARC-IB-15-003, PACKAGE SERVICES FORUM RECAP 3-6 (2015).

Second, based in part on shifting consumer expectations, major e-retailers and merchants have taken in-house more of the logistics and delivery operations traditionally handled by national package delivery providers such as the Postal Service, UPS, and FedEx. E-commerce retailers have started building decentralized warehouses that are closer to consumers, and some have even invested in building transportation networks and conducting their own "ship from store" or order fulfillment deliveries.[40] Of particular note, Amazon has been developing its own last-mile delivery capabilities. In a September 2015 submission to the Office of Communications (Ofcom), the government regulatory and competition authority for the postal industry in the United Kingdom, Royal Mail estimated that Amazon's efforts to build its own logistics network in the United Kingdom had halved the rate of addressed parcel volume growth available for Royal Mail to deliver.[41] In fact, Royal Mail reported, Amazon at that point "already deliver[ed] as many items as some of the largest national carriers."[42] This shift by major retailers toward more in-house handling of deliveries – many of which otherwise would have been handled by the Postal Service under negotiated service agreements or otherwise – could dramatically impact competition in the domestic package delivery market even in the near term.

Third, recent technological innovations have led to a surge in the number of firms providing last-mile delivery. The Postal Service's nationwide universal service network, built around its requirement to visit virtually every delivery address at least six days per

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[40] *Id.* at 5-6.

[41] Royal Mail plc, Response to Ofcom's July 2015 Discussion paper: Review of the Regulation of Royal Mail (Sept. 18, 2015), at 30, https://www.ofcom.org.uk/__data/assets/pdf_file/0017/72053/royal_mail.pdf.

[42] *Id.*

week, has historically given it a natural advantage in providing affordable last-mile DDU delivery.[43] However, the various participants in the e-commerce economy now have more choices for last-mile delivery, increasing the level of competition in this traditionally cost-heavy component of the market. Barriers to entry are low for innovative technology firms such as Uber and Instacart, which are using crowd-sourced labor to establish successful last-mile delivery options in increasing numbers of localized areas (typically large cities). These market disrupters will necessarily compete aggressively for market share, thus constraining the Postal Service's pricing flexibility over time. Other innovations such as driverless cars and drones have increased the possibilities for future growth.[44] As these last-mile options continue to grow, the Postal Service is likely to face increased competition in urban areas, while still being required to provide delivery services in more costly rural areas where fewer options are available.

A comparison of the competitive mail mix between 2012 and 2016 demonstrates the dramatic impact these fast-moving market changes could have on the Postal Service's competitive position. The proportion of domestic DDU packages to total competitive volumes doubled over the period (from [redacted] to [redacted]), as did

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[43] The Postal Service's extensive universal service network leads to economies of scope in last-mile delivery. *See, e.g.*, RM2016-2, Bradley Declaration at 3-4. However, there is no basis for the Commission to consider that it must use the "appropriate share" provision as a means of raising the Postal Service's prices to account for these economies of scope. As an initial matter, these economies flow from the fact that the Postal Service maintains an extensive network in order to provide universal service, which should not be treated as an artificial advantage that must be counteracted through the appropriate share provision. *Cf.* FTC Report at 49 ("Any scope economies that the USPS enjoys may naturally flow from market conditions relating to universal mail service."). Using the appropriate share for that purpose would instead prioritize the interests of the Postal Service's competitors over the interests of consumers and competition generally. Moreover, any lingering concerns should be dispelled by the fact that the Postal Service allows its competitors to access its last-mile delivery network through its Parcel Select products. *Cf.* FTC Report at 50 (noting that the existence of Parcel Select mitigates any concerns about economies of scope being an artificial advantage).

[44] *See* UNITED STATES POSTAL SERVICE OFFICE OF INSPECTOR GENERAL, RARC-WP-16-012, TECHNOLOGICAL DISRUPTION AND INNOVATION IN LAST MILE DELIVERY 1, 4 (2016).).

the proportion of packages delivered on behalf of the Big Three (from [redacted] to [redacted]).[45] Thus, while the Postal Service has experienced an early surge of success in providing last-mile service to meet increased customer expectations, that success is highly dependent on a small number of customers, [redacted]. If any of the Big Three were to shift a substantial portion of its volumes to its own, or another non-postal delivery network, that would have a substantial impact on the Postal Service's competitive business.

The changes to the market and competitors discussed above have resulted in a market that is <u>more</u> competitive on multiple levels (including last-mile delivery) than it was five years ago, making it highly unlikely that that Postal Service could obtain any unfair competitive advantage at all, much less one that would be significant enough to warrant an increase in the appropriate share contribution requirement. In light of these ongoing market changes, the Commission should set the minimum contribution level at zero or, at a minimum, reduce it from its current level, but certainly should not raise it.

D. The Postal Service's Historical Contribution Levels Alone Do Not Support Changing the Current Appropriate Share Requirement.

Over the last five years, contribution from the Postal Service's competitive products has equaled the following shares of institutional costs:

[45] RM2017-1 Analysis-nonpublic, tab 2, cells G25, G29, K25, and K29.

COMPETITIVE PRODUCT CONTRIBUTION SHARES	
Fiscal Year	Contribution as a Share of Institutional Costs
2012	7.49 %
2013	11.64 %
2014	12.61 %
2015	13.34 %
2016	16.50 %

Although the Postal Service's competitive products have consistently contributed more than 5.5 percent to institutional costs over each of the past five years, as discussed in Section I above, this alone does not justify a change in the appropriate share requirement. As the Commission has previously noted, the appropriate share is a floor, not a maximum.[46] Accordingly, the Postal Service is expected to "generate contributions in excess" of that requirement.[47]

Moreover, as discussed in sections II.B and II.C above, a substantial percentage of the Postal Service's modest growth in market share is inherently at risk, [redacted]. If the Postal Service's largest three domestic competitive-product customers were to in-source last-mile delivery or to shift to other sources (such as crowd-sourced local delivery providers), then the contribution levels shown above might no longer be achievable.

III. CONCLUSION

There is no evidence that the competitive delivery market is suffering from a tilt in the Postal Service's favor that would warrant a correction mechanism, and so there is

[46] Order No. 26 at 72.

[47] *Id*.

no apparent regulatory purpose for keeping the current appropriate share level. Thus, the current minimum share of institutional cost recovery for competitive products – 5.5 percent – can be set at zero or at a minimum reduced. There is certainly no basis for raising it.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

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ATTACHMENT 1

APPLICATION OF THE UNITED STATES POSTAL SERVICE FOR NON-PUBLIC TREATMENT OF MATERIALS

In accordance with 39 C.F.R. § 3007.21, the United States Postal Service (Postal Service) hereby applies for non-public treatment of certain materials filed with the Commission in this docket. The materials pertain to: 1) customer identifying information; and 2) sensitive volume information about the Postal Service's competitive products, contained in the Postal Service's Initial Comments (Initial Comments) and supporting workpapers (Workpapers). This information is used as part of the Postal Service's analysis of the domestic package delivery market. A redacted copy of the Initial Comments and of the Workpapers are filed with this application. Nonpublic versions of these documents are being filed separately under seal with the Commission. The Postal Service hereby furnishes the justification required for this application by 39 C.F.R. § 3007.21(c) below.

(1) The rationale for claiming that the materials are non-public, including the specific statutory basis for the claim, and a statement justifying application of the provision(s);

Information of a commercial nature, which under good business practice would not be publicly disclosed, as well as third party business information, is not required to be disclosed to the public. 39 U.S.C. § 410(c)(2); 5 U.S.C. § 552(b)(3) and (4). The Commission may determine the appropriate level of confidentiality to be afforded to such information after weighing the nature and extent of the likely commercial injury to the Postal Service against the public interest in maintaining the financial transparency of a government establishment competing in commercial markets. 39 U.S.C.

§ 504(g)(3)(A).[1] Because the materials filed non-publicly in this docket fall within the scope of information not required to be publicly disclosed, the Postal Service asks the Commission to support the Postal Service's determination that these materials are exempt from public disclosure and grant the Postal Service's application for their non-public treatment.

(2) Identification, including name, phone number, and e-mail address for any third party who is known to have a proprietary interest in the materials, or if such an identification is sensitive, contact information for a Postal Service employee who shall provide notice to that third party;

Concerning the information contained in the Initial Comments and Workpapers, the Postal Service believes that the third parties with an interest in the materials are the customers whose identities are revealed in the Initial Comments and in the market analysis performed by the Postal Service.

The Postal Service maintains that customer identifying information should be withheld from public disclosure. Therefore, rather than identifying the customers, the Postal Service gives notice that it has already informed the customers that have a proprietary interest in the materials of the nature and scope of this filing and their ability to address their confidentiality concerns directly with the Commission. The Postal Service employee responsible for providing notice to the customers with proprietary interests in the materials filed in this docket is Mr. John F. Rosato, Attorney, United States Postal Service, 475 L'Enfant Plaza, SW, Room 6236, Washington, DC 20260, whose email address is John.F.Rosato@usps.gov, and whose telephone number is 202-268-2990.

[1] The Commission has indicated that "likely commercial injury" should be construed broadly to encompass other types of injury, such as harms to privacy, deliberative process, or law enforcement interests. PRC Order No. 194, Second Notice of Proposed Rulemaking to Establish a Procedure for According Appropriate Confidentiality, Docket No. RM2008-1, Mar. 20, 2009, at 11.

(3) A description of the materials claimed to be non-public in a manner that, without revealing the materials at issue, would allow a person to thoroughly evaluate the basis for the claim that they are non-public;

In connection with its Initial Comments, the Postal Service performed an analysis of the domestic package delivery market, which includes the identities of certain customers who send packages via the Postal Service. The results of this analysis are contained in the Initial Comments and Workpapers filed today. These materials are under seal, with redacted copies filed publicly, after notice to the customers. The Postal Service maintains that the redacted portions of the Initial Comments and Workpapers should remain confidential.

In addition to redactions that protect the identities of specific customers, the redactions applied to the Workpapers also protect commercially sensitive information about some of the Postal Service's competitive products, which are not otherwise made public. Such information includes the breakdown of the "ground" category of the public CRA, filed in folder USPS-FY16-1, into various subcomponents.

(4) Particular identification of the nature and extent of commercial harm alleged and the likelihood of such harm;

If the redacted portions of the Initial Comments and Workpapers were to be disclosed publicly, the Postal Service considers that it is quite likely that it, and the affected customers, would suffer commercial harm. Should the redacted materials in the Initial Comments and Workpapers be disclosed publically, an affected customer could use this information (in combination with other publically available information about the other affected customers) to assess their negotiating power relative to the other affected customers.

(5) At least one specific hypothetical, illustrative example of each alleged harm;

Identified harm: Public disclosure of the redacted information in the Initial Comments and Workpapers could be used to the detriment of the Postal Service.

Hypothetical: One of the customers whose identity is contained in the redacted materials obtains copies of the unredacted version of those materials from the Postal Regulatory Commission's website. It then analyzes the documents (which includes sensitive information about the Postal Service's competitive products) to assess its negotiating power vis-à-vis the other customers whose identities are also included in the unredacted materials. This customer then uses the non-public and other publicly available rate information to insist that it must receive lower rates than those the Postal Service has offered it, or it will not use the Postal Service for its delivery needs.

(6) The extent of protection from public disclosure deemed to be necessary;

The Postal Service maintains that the redacted portions of the materials filed non-publicly should be withheld from persons involved in competitive decision-making in the relevant market for domestic parcels products. However, such information may be made available to such individuals' attorneys or consultants only to the extent necessary to facilitate their informed participation in this Docket.

(7) The length of time deemed necessary for the non-public materials to be protected from public disclosure with justification thereof;

The Commission's regulations provide that non-public materials shall lose non-public status ten years after the date of filing with the Commission, unless the Commission or its authorized representative enters an order extending the duration of that status. 39 C.F.R. § 3007.30.

(8) Any other factors or reasons relevant to support the application.

None.

Conclusion

For the reasons discussed, the Postal Service asks that the Commission grant its application for non-public treatment of the identified materials.